IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. [redacted] 75-1299

SHELL OIL COMPANY, ET AL.,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

CONDITIONAL CROSS-PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. A-551

SHELL OIL COMPANY, ET AL.,
Petitioners,

v.

FEDERAL POWER COMMISSION,
Respondent.

CONDITIONAL CROSS-PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Shell Oil Company, *et al.* (hereinafter referred to as "Producers") conditionally cross-petition for a writ of certiorari to review the Judgment of the United States Court of Appeals for the Fifth Circuit entered in this case on October 14, 1975, in the event petitions for a writ of certiorari filed by other parties below are granted by this Court.

OPINIONS BELOW

The Opinion of the Court of Appeals is reported at 520 F.2d 1061, *et seq.,* and its Opinion On Petitions for

Rehearing issued January 14, 1976 is reported at 525 F.2d 1261, which Opinions appear in the Chevron Appendix, pp. A-1 to A-45; B-1.[1] The Opinion of the Federal Power Commission, Opinion No. 699 is reported at 51 F.P.C. 2212, *et seq.* and appears in the Chevron Appendix, pp. C-1 to C-282. Opinion No. 699-H of the Federal Power Commission on rehearing is not yet reported but appears at pages D-1 to D-158 of the Chevron Appendix.

JURISDICTION

The Judgment of the Court of Appeals was entered on October 14, 1975, and was clarified by an Opinion Denying Petitions on Rehearing entered on January 14, 1976. We invoke the jurisdiction of this Court under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717(r)(b) (C.A., pp. E-1 to E-10).

QUESTIONS PRESENTED

In light of the Opinions and Judgment below, and the pending proceeding before the Federal Power Commission entitled "National Rates For Jurisdictional Sales Of Natural Gas Dedicated To Interstate Commerce On Or After January 1, 1973", for the period January 1, 1975 to December 31, 1976, Docket No. RM75-14, Producers deem petitions for writs of certiorari in this case premature, and questions raised thereby not yet ripe for review by this Court, except for the Petition filed by Chevron Oil Company on Question No. 2 below, which goes to the juris-

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1. Simultaneously herewith, Petitioner The California Company, A Division of Chevron Oil Company, is filing in No. ________, Appendices to their Petition for Writ of Certiorari containing the opinions below, the agency opinions, and statutes involved. Reference to the "Chevron Appendix' or "C.A." are to that document.

diction of the Federal Power Commission. However, if this Court concludes otherwise and grants petitions filed by other parties, the following questions necessarily are also presented:

1. Whether the Commission is required by the Natural Gas Act, and Court decisions under that Act, to determine the ceiling price for new gas within the range of cost estimates contained in the record, or whether in the alternative, the Act and Court decisions require the Commission to consider the end result of its Orders on the supply of natural gas in the United States, and on the ability of interstate pipelines to compete for available new gas supplies, and if the Commission finds upon such consideration that the cost-based rate will not elicit adequate gas supplies and will not permit interstate pipeline companies to compete for available supplies must the Commission then adjust the rate upward accordingly?

2. Whether the Commission committed error in issuing a retroactive rate order requiring producers to waive certain rights which the Commission had granted in earlier opinions and which had been finally affirmed after Court review, in order to avail themselves of the rates which the Commission now finds to be just and reasonable for new gas?

3. Whether the Commission has understated the range of cost estimates utilized by it in establishing the national ceiling rate through its failure to make proper adjustments for the decline in productivity of drilling and the increase in various cost components which occurred subsequent to the filing of the data utilized by the Commission Staff in making the

cost estimates, including specifically increases in lease acquisition costs and federal income taxes?

STATEMENT OF FACTS

On April 11, 1973 the Commission issued a Notice of Proposed Rulemaking in Docket No. R-389-B to determine a national rate applicable to sales of "new" gas, as defined in its Order.

Comments of interested parties were filed in May of 1973, containing voluminous cost and non-cost evidence. Replies to those Comments were filed in June of 1973. On March 21, 1974, the Commission issued a second Notice, attaching a revised Staff nationwide cost study and a Staff study of American Gas Association reserve additions. Following this study a conference was held by the Commission on April 16, 1974. Comments were then again filed on May 7, 1974, directed primarily to the Staff's studies, and replies filed on May 28, 1974. Again, the Producers' Comments, and those of some of the other parties, contained extensive testimony dealing with cost and non-cost issues.

On June 21 1974 the Commission issued Opinion No. 699 (C.A., pp. C-1 to C-282) prescribing a single uniform national base rate of 43 cents per Mcf. The base ceiling rate was subject to adjustment upward and downward for Btu content, and was adjusted upward for gathering performed by producers, and for state or federal production, severance or similar taxes. The Commission made extensive findings with reference to the natural gas shortage, and stated the following:

> "[O]ne of the primary goals which we have in establishing a national r. te is to set a rate sufficient to

> encourage the exploratory and developmental drilling which is required to discover and produce the natural gas supplies necessary to attain an objective of self-sufficiency in natural gas supplies available for delivery to the ultimate consumer." (C.A., p. C-20)

The Commission further found that the pervasive gas shortage "requires that this Commission promulgate producer pricing policies which will attract long-term dedications of new natural gas supplies to the interstate market." The Commission made extensive findings that the gas well exploratory and developmental drilling was inadequate (C.A., p. C-26), that additional gas discoveries were required (C.A., pp. C-26, 27) that massive capital commitments would be called for to finance these programs (C.A., p. C-28), and that it had the regulatory obligation to establish a uniform national rate to provide incentives to stimulate exploration and development (C.A., pp. C-28, 29). The Commission found that there was no reliable method to accurately quantify the amount of additional supplies attributed to price increases; however, it recognized that when the drilling trends were compared with price trends it was apparent that the increase in the price at which the natural gas could be sold in the interstate market would bring forth new suppplies of natural gas for dedication to that market (C.A., p. C-35). The Commission then discussed the curtailment programs of the various pipeline companies, and found that:

> "[T]he nation is still and will continue to be confronted with the national energy emergency resulting from a shortage of basic fuels required to maintain a productive economy." (C.A., p. C-40)

Nevertheless, after making all of these findings with reference to gas supply and the price supply relationship,

the Commission proceeded to base its national ceiling rate entirely on cost evidence in the record (C.A., p. C-130).

The Commission found a cost range of 37.54 to 42.74 cents[2] and fixed the national ceiling rate at the upper end of that range, however, the Commission conceded that the cost estimates were imprecise (C.A., p. C-128) and that the rates so determined would not have the effect of dampening demand for natural gas, as the price it fixed was still much less than the price of substitutable fuels (C.A., pp. C-129, 130; pp. C-42, 43). The Commission concluded that court decisions, primarily the *City of Detroit Case*,[3] did not permit it to exceed that cost range, even though the evidence showed that intrastate market prices onshore were substantially higher and that interstate pipelines could not compete for new gas supplies onshore because of the Commission's ceiling. The record demonstrated that the Department of Interior was rejecting bids for gas-prone leases in the offshore Federal Domain unless the bidder based his bid on an estimate for the gas price in excess of the Commission's ceiling rate. The evidence also showed that the commodity value of natural gas was substantially higher than the ceiling rate, and that the capital requirements of the industry exceeded the revenue which would be derived from those rates.

Commissioners Brooke and Moody dissented on the grounds that the majority of the Commission had not made the "pragmatic adjustments" in the ceiling rate indicated

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2. On rehearing, the Commission redetermined the cost range to be from 47.82 cents to 51.46 cents (C.A., p. D-36).

3. *City of Detroit v. F.P.C.*, 230 F.2d 810 (D.C. Cir. 1956), cert. denied, 352 U.S. 829 (1956).

by its supply and demand findings. In the words of Commissioner Brooke, the non-cost adjustments were "woefully lacking".

Extensive Applications for Rehearing were filed and the Commission held oral argument on August 22 and 23, 1974. Pipelines, distribution companies, consumers, and producers attacked the Commission ceiling rate as being too low, stating that interstate pipeline companies could not compete for available new gas supplies onshore at that level and that the Commission's ceiling price would severely retard offshore development for new non-associated gas supplies.

On December 4, 1974 the Commission issued Opinion No. 699-H (C.A., pp. D-1 to D-158), revising upward the national ceiling rate for new gas to 50 cents, with an additional one-cent increase effective January 1, 1975, also based entirely on a revision in its cost estimates, to a range of 47.82 cents to 51.46 cents. In addition to the base ceiling rate, the Commission allowed the ceiling rate to be increased by the amount of state or federal severance or production taxes, or similar taxes, by an upward or downward Btu adjustment from a base of 1,000 Btu per cubic foot, and by gathering increments varying between production areas. Petitions for Review were filed in the Court of Appeals for the Fifth Circuit.

On the same day that the Commission denied rehearing in this case in Opinion No. 699-H, it issued an Order in a new docket, Docket No. RM75-14, which undertakes a complete review of all of the rate ceilings decided in Opinion Nos. 699 and 699-H. The requirement for waiver of the refund work-off provision is not being reconsidered in Docket No. RM75-14. Voluminous Comments and

Reply Comments have been filed in this proceeding, and the proceeding is now pending, awaiting Commission decision.

In its Opinion issued October 14, 1975, 520 F.2d 1061, the Court of Appeals affirmed the Commission in all respects (C.A., pp.A-1toA-45). The Court of Appeals relied, on a number of specific issues, on the fact that the Commission was currently reconsidering these issues in the Biennial Review Case, Docket No. RM75-14, *supra.* In particular, the Court of Appeals held that the challenge raised by Producers that the Commission had not properly considered the end result of its rate structure, and had not properly considered the repeal of the depletion allowance on the Federal income tax allowed in producer rates, was premature, and would be reconsidered by the Commission in the Biennial Review Proceeding.

REASONS FOR GRANTING THE WRIT

I.

The Commission's Decision Below Is Based On An Error Of Law Which Will Be Repeated In Its Subsequent Opinion Unless Otherwise Directed By This Court.

In the case below, the Commission found that it was constrained by Court decisions to limit its ceiling rate for producers to a range indicated by the cost estimates in the record. Even though the Commission made specific findings on supply, market conditions, capital requirements, commodity value, and other factors which establish the necessity for a higher ceiling rate, the majority of the

Commission[4] held that it was prohibited by Court decisions from increasing the rate to the levels indicated by these economic factors.

Far from *requiring* the Commission to utilize cost in determining producer rates, as the Commission assumed (C.A., pp. C-127 to C-130), the Court has held that the Commission is *permitted* to utilize costs in determining producer rates, *provided* the "end result" is compatible with the public interest, see *Permian Basin Area Rate Cases,* 390 U.S. 747, 791, 796 (1968).

In the most recent producer rate case to be considered by this Court, *Mobil Oil Corp. v. F.P.C.,* 417 U.S. 283 (1974), this Court rejected an attack by some of the parties on the Commission's decision on the ground that it had no basis in costs. The Court stated:

> "Mobil's argument assumes that there is only one just and reasonable rate possible for each vintage of gas, and that this rate must be based entirely on some concept of cost plus a reasonable rate of return. We rejected this argument in Permian Basin and we reject it again here. The Commission explicitly based its additional 'non-cost' incentives on the evidence of a need for increased supplies. Obviously a price sufficient to maintain a producer, while not itself necessarily required by the Act (n. omitted), may not be sufficient also to encourage an increase in production." (417 U.S. at 316, 317, 41 L.Ed2d at 99-100)

Despite the clear language of *Permian* and *Mobil,* the Commission concluded that it would be committing legal

4. Two of the five Commissioners dissented on this question (C.A., pp. C-167 to C-170).

error if it established a ceiling rate which exceeded the range of the cost estimates in the record. This conclusion was reached despite its further findings that prices in the intrastate market were substantially in excess of the Commission's ceiling rate, and that interstate pipelines would be unable to purchase gas in competition with that market at the ceiling rate prescribed by the Commission (C.A., pp. C-129; C-218 to C-220; C-225).[5]

The record is clear that the impact of utilizing an average nationwide unit cost to form a nationwide ceiling rate is to confine exploration and development to the most favorable prospects which can be developed at costs which are below the average level, and exclude all projects believed to cost in excess of that level. The inevitable result, as noted in the dissenting opinion (C.A., p. D-145), is not a ceiling on profits but a decline in exploration, with a subsequent decline in long-term supply and an increasing gas shortage in the United States. As the Fifth Circuit notes:

> ". . . [T]he effort to protect the consumer interest as to price is at odds with the long range consumer interest in maintaining an adequate supply of natural gas for the interstate market." (C.A., p. A-18)

The Fifth Circuit lamented the "failure of the Commission to assess the consequences of its various policies" but finally concluded that the cost-based rate was experimental and that it was premature to find that it did not meet the end result test (C.A., p. A-45). Thus, the Commission is

5. See also FPC Bureau of Natural Gas Staff Report issued November 1975, showing average price for non-jurisdictional sales of natural gas for period January through June 1975 to be $1.259 per Mcf.

left undisturbed in its belief that it is required by the Court decisions to confine its ceiling rate to the range of cost studies in the record, even though it also finds that such a rate will prevent exploration, increase the gas shortage, and prevent adequate development of our natural resources. In the absence of a contrary decision by this Court, or a change in the Natural Gas Act by Congress, such a result becomes inevitable.

II.

The Commission's Requirement For A "Waiver" Of The Refund Credit Provision Amounts To A "Retroactive Rate Order" Prohibited By Law.

In four of its area rate decisions,[6] after fixing certain price levels as "refund floors" and requiring refunds of all amounts collected above those levels, the Commission provided that the refunds so ordered could be discharged through the dedication of additional gas reserves subsequently found in those areas at the rate of one cent per Mcf for each Mcf of new reserves discovered and dedicated to the interstate market. One of the reasons given by the Commission for this provision was to leave the

6. *Texas Gulf Coast Area Rate Case,* 45 F.P.C. 674, 18 C.F.R. § 154.109; reversed and remanded, *Public Service Commission of New York v. F.P.C.,* 487 F.2d 1043 (D.C. Cir. 1973), vacated and remanded, *sub nom. Shell Oil Co. v. Public Service Commission of New York,* 417 U.S. 964 (1974), affirmed on remand, 516 F.2d 746 (D.C. Cir. 1975); *Southern Louisiana Area Rate Case,* 46 F.P.C. 86, 18 C.F.R. § 154.105; affirmed, *Placid Oil Co. v. F.P.C.,* 483 F.2d 880 (1973), affirmed, *Mobil Oil Corp. v. F.P.C.,* 417 U.S. 283 (1974), *Other Southwest Area Rate Case,* 47 F.P.C. 99, 18 C.F.R. § 154.109 (a); affirmed, *Shell Oil Co. v. F.P.C.,* 484 F.2d 469 (5th Cir. 1973), cert. denied *sub nom. Mobil Oil Corp. v. F.P.C.,* 417 U.S. 973 (1974); and *Permian Basin Area Rate Case II,* 50 F.P.C. 313.

capital represented by these refunds in the hands of the producers to encourage additional exploration, and tie that exploration specifically to the pipelines served in that area (45 F.P.C. at 711). This provision of the Commission's Opinions was extensively challenged by the Public Service Commission of New York and Mobil Oil Corporation, and was affirmed by the Fifth Circuit in two separate opinions, *Placid Oil Co. v. F.P.C.*, 483 F.2d 880 (1973) and *Shell Oil Co. v. F.P.C.*, 484 F.2d 469 (1973). It was one of the issues raised on certiorari from the *Placid* case by Mobil, New York and MDG, and discussed extensively in this Court's Opinion in *Mobil Oil Corp. v. F.P.C.*, 417 U.S. 283 (1974), 41 L.Ed.2d 72, at 104-05. A contrary ruling by the District of Columbia Circuit in *Public Service Commission of New York v. F.P.C.*, 487 F.2d 1043 (1973) was vacated and remanded by this Court in *Shell Oil Co. v. Public Service Commission of New York*, 417 U.S. 964 (1974), and on remand the D.C. Circuit affirmed the Commission's Opinion, 516 F.2d 746 (1975).

Less than two weeks after this Court's decision in *Mobil, supra* (decided June 10, 1974), the Commission issued Opinion No. 699 here under review (June 21, 1974), wherein the Commission held that nationwide just and reasonable rate for all gas contracted for after January 1, 1973[7] was 42 cents per Mcf (increased by Opinion No. 699-H to 50 cents per Mcf). But then the Commission determined that some producers would not be entitled to collect the rate found to be just and reasonable for some or all of their new natural gas. The Commission decided (C.A., pp. C-109 to C-111; C-115, 116) that producers who elected to work-off their existing refund obligations,

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7. And the categories noted in the Commission's Opinion see C.A., p. .

as they were given the right to do in the four area rate decisions above cited, could not receive the just and reasonable rate for the gas so utilized, even though in all other respects it met the requirements to be classified as "new" natural gas.

Recognizing the questionable nature of an order which would deprive producers of a right just sustained by this Court only eleven (11) days earlier, the Commission sought to circumvent this problem by requiring the producer to "waive" his rights under the earlier area rate decisions in order to take advantage of the new nationwide ceiling rate (C.A., p. C-115). In so doing the Commission made a pretense of "substituting incentives" in requiring the producer to choose between the refund credit already given in the prior decisions and the rate which the Commission now found to be just and reasonable for the reserves currently being discovered. Yet, if the Commission's determinations of law were correct, the producers now are not required to choose, but have the right, which this Court has sustained, to receive the refund credit under the earlier decisions, and have the further right to receive whatever the Commission determines to be the just and reasonable rate for the new gas which they discover.

The Commission has overlooked the vital time factor involved in the two decisions. The earlier area rate decisions dealt with the just and reasonable rate levels for gas sold prior to the date of those decisions. The Commission's decision below makes no attempt to change those levels or refund floors. To do so would have been a retroactive rate order of the type prohibited by this Court's decision in *F.P.C. v. Hope Natural Gas Co.,* 320 U.S. 591, 618 (1944). Similarly, the Commission committed error by retroactively changing the *manner* in which those

refunds were to be discharged, *i.e.,* the dedication of new gas reserves instead of repayment of the money in cash.

The Court of Appeals sustained the Commission, saying that it was within the Commission's discretion to determine an alternative rate system substituting one incentive structure for another (C.A., pp. A-41, 42).In so holding however, the Court of Appeals also lost sight of the different *time* during which the respective structures apply. The rate structure in the area rate decisions applied for all time periods prior to those decisions, and up until June 21, 1974, the effective date of the Commission's Opinion here under review. The Commission acknowledges that reserves dedicated prior to that date will still receive the refund credit, provided those reserves did not receive the national ceiling rate for new gas.

What the Commission and the Court of Appeals failed to recognize, is that there was never any connection between the price received for the new reserves to be dedicated, and the fact that those reserves could be credited against the refund provision. The earlier decisions clearly contemplated the sale of those reserves at whatever the applicable just and reasonable rate was at the time the reserves were dedicated. In this respect, this case is clearly distinguishable from *Moss v. F.P.C.,* 502 F.2d 461 (D.C. Cir. 1974), relied upon by the Commission and the Court of Appeals. In the *Moss* case, the Commission set out an "optional" procedure which the producer could elect to follow or not. If he elected to follow the *optional* procedure, he was entitled to receive a rate higher than the current just and reasonable rate, in return for a waiver of other rights. In the case below, the producer was given no option to choose between a just and reasonable rate or a higher rate. On the contrary, the Opinion below unlaw-

fully deprives the producer of the just and reasonable rate unless he agrees to waive rights vested by another Commission opinion.

III.

The Commission's Cost Estimate Which Is the Sole Basis Of Its Ceiling Rate, Is Defective.

This Court in *Permian* approved the Commission's discretion to select various relevant costing components in arriving at a cost estimate. There are however, several errors in the Commission's costing estimate which are so patent and obvious that the failure to correct these errors must inevitably arrive at a costing result which will fail to return to the entire producing industry even its national average costs. We will point out only three of these costing errors, which have the most substantial impact. In so doing, we emphasize the Commission's own findings that its cost estimates are not "precise" (C.A., p. C-47) and that the Commission has only attempted to establish a "permissible zone of deviation" for costs (*Id.*). The uncertain nature of these costing studies re-emphasizes our first point, *supra*—that the Commission must be instructed that it is not confined to such cost studies in arriving at the just and reasonable rate for producers.

A. The Commission Has Failed To Recognize And Allow For The Trend In Declining Productivity.

In the language of the Court of Appeals:

> "One of the most important and hard to predict variables in the cost-based formula is productivity,

> the amount of natural gas that will be added to non-associated gas reserves for every foot drilled resulting in some addition to those reserves." (C.A., p. A-31)

The dissenting opinion below notes:

> "If we err in predicting productivity, we destroy the integrity of the whole rate structure." (C.A., p. C-179)

In the decision below and prior decisions, the Commission has recognized those phenomena which are peculiar to the oil and natural gas producing industries. These phenomena have two aspects:

(a) The number of gas reservoirs located in the Continental United States is finite. Exploration in search of those reservoirs throughout over the 100-year history of this industry has resulted in the discovery of the most accessible, and therefore lower cost, of these reservoirs, with the result that those remaining to be found must be discovered in areas of increasing difficulty, such as greater depths, off-shore water locations, etc. It also means that the largest reservoirs have probably already been found, and that those remaining to be found will be smaller in volume, so that future wells (although more expensive) will have less "productivity" than wells drilled to more prolific reservoirs in the past.

(b) Each producer has a catalog of "prospects" which he hopes may be productive of gas, but whose productivity, if any, cannot be ascertained without large capital expenditures. One of the factors in the calculus involved in the decision of whether these expenditures will be made, is the question of the revenue to be received from the product, if any, to

be produced from the reservoir. As the price per unit of the product increases, the size of the reservoir which needs to be discovered in order to return the exploration and development costs is reduced. Thus, contrary to the situation in all other industries regulated as utilities, the *price* permitted by the Commission *determines* the *cost* which will be incurred by the producer in the attempt to find reservoirs which he can sell at the predetermined price. This factor has its impact upon "productivity" as the higher the price, the lower the "productivity" which can be accepted by the producer in making the expenditure.

These two inherent characteristics of the producing industry are recognized in the Opinion below (C.A., pp. C-64, 65) and in prior proceedings, *e.g., Texas Gulf Coast Area Rate Proceeding,* 45 F.P.C. 674, 703 (1971).[8] Yet while accepting the theoretical validity of these characteristics, the Commission refuses to consider them in its determination of a productivity number which is one of the most important inputs in the costing formula. The Commission utilized an average productivity of a seven-year year period from 1966 through 1972 and arrived at a productivity of 485 Mcf per foot (C.A., p. C-261) Adding the additional year of 1973, which was not available to the Commission at the time the initial Opinion No. 699 was issued in June of 1974, but was available prior to the time the Opinion on rehearing was issued in December of 1974, the data series reads as follows:

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8. Reversed, *Public Service Commission of New York v. F.P.C.*, 487 F.2d 1043 (D.C. Cir. 1973), vacated and remanded, *sub nom. Shell Oil Co. v. Public Service Commission of New York*, 417 U.S. 964 (1974), affirmed on remand, 516 F.2d 746 (D.C. Cir. 1975).

	Mcf/ft.	Mcf/ft.
1966	630	660
1967	806	830
1968	614	610
1969	318	290
1970	472	410
1971	427	380
1972	286	280
1973	113	104

Those data available to the Commission show an unmistakable downward trend in productivity, which is to be expected if the Commission's theoretical premises, as noted above, are accurate. By utilizing an average of the seven-year period to project into the future, even for the year 1973 where data shows affirmatively to be substantially less than the projection, the Commission ignored the downward trend of productivity in establishing its cost-based ceiling. The impact of this error was substantial. If the Commission had simply used the seven-year average, including the year 1973 instead of the outdated year 1966, the average productivity for that period would have been 433 Mcf/ft., and its cost calculation would have increased by 14 cents per Mcf.

B. The Commission's Formula Grossly Understates Lease Acquisition Costs As Shown By The Record.

The Commission's method has been to estimate lease acquisition costs by deriving a ratio between such costs and the statistical average of national successful well costs. The time period utilized by the Commission in this case is the five-year period 1967 through 1972. Under this method, lease acquisition costs were estimated by the Commission to be 67 percent of successful well costs.

In the years since 1972, this percentage has been completely distorted by the large expenditures required for bidding for leases in the Outer Continental Shelf owned by the Federal Government. The trend is apparent from the total bonus bids on Outer Continental Shelf lease sales shown in Appendix A, which shows the lease sales from 1954 through 1974. A dramatic increase occurred in 1972, which is not reflected by the Commission's method. The correction of this error alone would result in an increase in the national ceiling rate of approximately 25 cents per Mcf.

C. However The Commission Computes The Costs, It Erred In Failing To Include A Component, Or Allowance, For Federal Income Tax Liability.

Although the Commission historically has adopted, and this Court has approved, an area average cost methodology for determining the rates producers who sell gas in interstate commerce are allowed to charge for such sales, with respect to federal income tax cost component the Commission dramatically has departed from the procedure for determining costs used with respect to all other elements of cost. Instead, the Commission has stated, contrary to *all* record evidence, that the only way it would allow any producer to recover the liability for federal income tax is for such producer to file a special, separate pleading, *annually,* asking for special relief from the Commission's established rate merely to recover its federal tax costs. This position of the Commission is wholly at odds with the nationwide *average* cost approach it espouses with respect to all other cost factors.

Further, as a condition to recovery of federal income taxes incurred on the sale of an Mcf of gas in interstate

commerce, the Commission requires the producer to file his actual federal income tax return (C.A., pp. C-117, 118). This concept is so totally out of touch with reality as to be meaningless. The federal income tax paid in any one taxable year bears, and can bear, no relation to any producer's tax on interstate natural gas revenues. The reason for this is simple: natural gas producers file only one federal income tax return which, by law, relates to tax liability on income from many sources including natural gas sold in interstate commerce, not covered by the nationwide ceiling rate set by the Commission. The Commission's Order requires the producer of gas to segregate its revenues, deductions, and tax liability allocable to the category of gas to which the ceiling rate applies, from the deductions and tax liability attributable to all income.

As if these practical problems were not sufficient to make the Commission's approach to recovery of taxes unworkable, the Commission's Order also fails to take into account that revenues under its rate will not, and indeed cannot, be correlated to a tax year or to expenses which qualify for deductions in a tax year.

In a more recent decision in the Nationwide Rate For Flowing Gas Case, Docket No. R-478, issued December 31, 1975, the Commission included a component for federal income tax in the cost calculation for flowing gas. While the Court of Appeals' Opinion below leaves the Commission free to follow a similar procedure in the Biennial Review Case, Docket No. RM75-14, this error remains uncorrected in the Opinion here under review.

The Commission's method for recovery of federal income tax liability in Opinion Nos. 699 and 699-H will

not, and cannot, provide a producer the ability to recover the federal income tax liability incurred on the sale of natural gas in interstate commerce.

CONCLUSION

The Commission is now engaged in a comprehensive review of the ceiling rates established in the Opinion below. We therefore believe that this Court's consideration of those rates at this time is premature, and the Commission should be left to complete its task. If, however, this Court decides to grant any petition for certiorari from the Commission's Opinion, the questions raised herein should also be considered by the Court.

Respectfully submitted,

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APPENDIX A

OUTER CONTINENTAL SHELF LEASE SALES
Through 1974

Date		State	Acres Offered	Acres Leased	Total Bonus
10-13-54		Louisiana	748,000	394,721	$ 116,378,476
11- 9-54		Texas	111,788	67,149	23,357,029
7-12-55		Texas	216,000	149,760	8,437,462
7-12-55		Louisiana	458,095	252,807	100,091,263
2-26-59		Florida	458,000	132,480	1,711,872
8-11-59	*	Louisiana	81,813	38,820	88,035,121
2-26-60		Texas	437,760	240,480	35,732,031
2-26-60		Louisiana	1,173,223	464,046	246,909,784
3-13-62		Louisiana	1,808,276	951,811	177,260,305
3-16-62	*	Texas	90,720	28,800	557,720
3-16-62		Louisiana	1,780,265	927,746	267,775,727
10- 9-62	*	Louisiana	33,855	16,178	43,887,359
5-14-63		California	669,777	312,945	12,807,587
4-28-64	*	Louisiana	34,028	32,673	60,340,626
10- 1-64		Oregon	836,134	425,433	27,768,772
10- 1-64		Washington	253,940	155,420	7,764,928
3-29-66	*	Louisiana	35,993	35,056	88,845,963
10-18-66	*	Louisiana	227,898	104,717	99,164,930
12-15-66	*	California	1,995	1,995	21,189,000
6-13-67		Louisiana	971,489	744,456	510,079,178
2- 6-68		California	540,609	363,181	602,719,262
5-21-68		Texas	728,551	541,304	593,899,046
11-19-68	*	Louisiana	46,824	29,682	149,868,789
1-14-69	*	Louisiana	96,389	48,505	44,037,339
12-16-69	*	Louisiana	93,764	60,153	66,908,196
7-21-70	*	Louisiana	73,360	44,642	97,769,013
12-15-70		Louisiana	593,485	546,398	845,877,860
11- 4-71	*	Louisiana	55,872	37,222	96,304,522
9-12-72		Louisiana	366,682	290,321	585,827,925
12-19-72		Louisiana	604,029	535,874	1,665,519,631
6-19-73		Texas	697,643	547,173	1,591,397,380
12-20-73		Alabama, Florida & Mississippi	817,397	497,108	1,491,617,119
3-28-74		Louisiana	930,918	421,218	2,092,510,854
5-29-74		Texas	1,355,678	565,112	1,471,851,831
7-30-74		Texas & Louisiana	1,298,739	100,241	30,236,800
10-16-74		Louisiana	1,421,546	675,587	1,428,261,330
TOTALS			20,150,535	10,781,214	14,792,702,030

* Drainage sale